# CITY OF LODI
# INFORMAL INFORMATIONAL MEETING
# "SHIRTSLEEVE" SESSION
# CARNEGIE FORUM, 305 WEST PINE STREET
# TUESDAY, AUGUST 20, 2002

An Informal Informational Meeting ("Shirtsleeve" Session) of the Lodi City Council was held Tuesday, August 20, 2002 commencing at 7:05 a.m.

## A. ROLL CALL

Present: Council Members – Hitchcock, Howard, Land, and Nakanishi (arrived at 7:08 a.m.)

Absent: Council Members – Mayor Pennino

Also Present: City Manager Flynn, City Attorney Hays, and Deputy City Clerk Taylor

## B. CITY COUNCIL CALENDAR UPDATE

Deputy City Clerk Taylor reviewed the weekly calendar (filed).

## C. TOPIC(S)

C-1 "Energy Portfolio Restructure"

Electric Utility Director Vallow distributed copies of a chart depicting Lodi power costs with and without restructuring (filed), and presented a report on current negotiations to restructure the City of Lodi Energy Portfolio with the use of overheads (filed).

Mr. Vallow reported that last year consumers reduced their usage to save money and conserve energy, and that currently the market and energy costs are more stable and moderate. He shared that Lodi has experienced more than 31 straight days of 90° plus weather this year, a record for the last 10 years. As a result, conservation efforts have relaxed, and customers are using approximately 15% more energy than last year in communities across the state. He shared that so far in July Lodi's billing process is exceeding the Home Comfort Discount quarterly allotment of $450,000, with August and September billing still to be calculated, which proves the discount was positive and the outcome has been valuable to the community.

In response to Council Member Nakanishi, Mr. Vallow reported that the average customer savings is $12 to $15 dollars on the electric service portion of their statements. He added that some bills may be lower, but many would appear higher because customers used more energy during this unusually hot July, and statements not only include electric usage, but fees for water, sewer, and garbage services.

Mr. Vallow read from a recent article in the American Public Power Association (APPA) newsletter, a quote by Moody Senior Vice President Dan Ashenbach which stated, "We also note that public power's decisions to maintain ownership of generation have made them long on resources, thus limiting exposure to wholesale market volatility." He shared that this is the same Moody representative who in 1999 wanted to downgrade all municipal utilities for holding on to electric generation. Mr. Vallow pointed out that City activity is based on making sound decisions in response to rating agency opinions on building regeneration, entering into long-term contracts, or chancing an industry downgrade. He shared that the report further stated, "If utilities do not know the credit standing of a supplier with whom they are doing business, they run the risk that the supplier could default on the contract and create difficulties for the municipal electric facility." Mr. Vallow shared that while that appeared absurd talk in 2000, with Enron and Calpine corporations in the lead, all power marketers are currently rated at or below junk bond status at this time, a reflection of how quickly the market has changed in two years.

Electric Utility Director Vallow reported that Lodi reacted conservatively in entering into an April 2001 contract with Calpine for $65 per Megawatt-hour (MWh) when the State was entering into $110 MWh contracts. Lodi specifically went with Calpine, which was actually building facilities at that time, making them a more stable counterpart. Recently, Calpine has been downgraded indicating a perceived risk for Lodi. Should Calpine follow the path of Enron, the power market will rise and Lodi will have to return to the market to replace the existing high-cost contract with a more expensive one. Since February, the Electric Utility Department (EUD) focus has been to refinance existing debt and take out working capital for a restructured portfolio. In March, market activity slowed due to industry investigations and drops in the stability of power marketers. The situation is now improved, and EUD has engaged in negotiations to restructure the Calpine agreement to reduce Lodi's level of counter-party credit risk of approximately 20% of peak load, which is only 30% of Lodi's energy over an annual basis. EUD is conservatively working to shape bulk power cost to more closely match load and revenue growth, reduce the cost, and accelerate cash reserve growth, enhancing our financial status with rating agencies.

In response to Council Member Land, Mr. Vallow reported the City's reserve fluctuates daily as receivables and payables shift, but at the end of July it was approximately $4.5 million including reserves and cash. Further, Lodi is eligible for approximately $3 million through Northern California Power Agency (NCPA) as a result of pending settlements with Pacific Gas and Electric (PG&E) and other NCPA members as a result of activities and agreements during 2001. He stated that during the next ten years, EUD would focus on delivering a reasonably competitive rate to customers, lower than Stockton and other outlying areas. The contract with Calpine has value, a term, and a cash flow associated with it, similar to that of a bond. Like a bond payment stream, the energy contract varies as interest rates and underlying values affect it. The City has successfully taken an opportunity in the past to refinance bond debt, most recently restructuring a bond for a savings of 12%, far exceeding the normal guide of 5%. Lodi would like to repeat that success with the current Calpine power contract.

At the request of Mayor Pro Tempore Hitchcock and Council Member Howard, Mr. Vallow shared that the City pays $65 KWh on our current Calpine contract, and identified the specific language within the contract that allows for negotiations toward restructure. The contract signed last year was for a ten-year term, expiring December 31, 2011, but noted that recently long-term power prices have dropped to historically low levels, just like interest rates. Mr. Vallow reported that the City has measured the current contract value at $65 KWh x cost of energy x ten years, and has set a goal to refinance the contract and capture the savings.

In response to Council Member Nakanishi, Mr. Vallow clarified this would not be a contract prepayment, but rather buying out the value of the contract so it could be destroyed. The City would capture the savings of the difference between the current market value and the contract value, and Calpine, who has no access to capital markets, would receive the cash flow it needs right now to continue building. The benchmark has been that saving 5% or more makes good financial sense. Lowering risk and leveling cash flow are two additional points to consider, but just lowering the cost is a good reason to move forward.

Council Member Land commented that the many changes since last year should dictate that Calpine be approached to provide a good contract or renegotiate the current one. Electric Utility Director Vallow stated the current contract is valid, and was negotiated, signed, and accepted by both parties, and that the City would be best served by negotiating a restructure to permit taking advantage of the current market value difference and releasing its exclusive dependence on Calpine.

Council Member Hitchcock commented that the City should not be responsible for continuing to meet the terms of its contract with Calpine should it fail to remain solvent. Mr. Vallow noted that specific contract language actually provides that if a company does not exist or fails to supply power, the City must buy power from the market. For example, if the City buys power from the market at $20 below the contract value, the City still owes either the bankruptcy court or the company's successors that $20 difference. If the City buys power from the market at $20 above the contract value, it would be due the difference, but would also be responsible to collect this amount through bankruptcy or a non-existent corporation. He stated this contract is still better than most, as it allows the City to compel through the courts for a renegotiation. At the time staff was shopping for a long-term contract, only Enron and Calpine were available, and the State, the biggest buyer during that time, now has several cases pending in court.

At the request of Council Member Nakanishi, Mr. Vallow stated that ensuring the Lodi load is lower than the restructured cost is vital, and that comparisons must be made on a KWh basis, not an expenditure basis. He shared that while NCPA is an active and successful advocate in representing the needs of its organization, it represents all members as a whole and does not address individual member needs. EUD recently hired Sandra McDonald, an investment-banking consultant, to lead the renegotiation along with Boris Prokop of Borismetrics. With cost and load fluctuation, Lodi has a summer surplus and an energy deficit in the winter. The goal is to lose the summer surplus as a retail seller, and lower our exposure to the market in buying energy for peak load. Lodi had to enter into a long-term contract that covered our largest risk position to ensure we met our highest load needs. Current renegotiations include reducing the contract from ten- to three-year terms with one-year renewal options. The cost to be rid of the current contract will be about $40 million, and then Lodi will refinance a new agreement. The sum of the two documents will be less than the current contract, but will possess added value of lower cost and increased control.

At the request of Mayor Pro Tempore Hitchcock, Mr. Vallow shared that building generation is not a consideration while the City is involved in a purchase contract, and are not in need of 'around-the-clock' resources. The subject will become a topic of discussion in the future as agreements expire and more power marketers go out of business and are downgraded. When feasible, Lodi would likely join with a group of NCPA members with opposite load patterns to benefit swapping out peak needs on an equal value basis. He shared that the current value of power is $37 MWh base load, escalating to as much as $52 MWh over a twelve-year period of time based on the current power market. Mayor Pro Tempore Hitchcock stated she would support Lodi becoming more aggressive in buying generation and getting involved with NCPA as a long-term goal.

In response to Council Member Howard, Mr. Vallow stated signing multiple short-term contracts with different companies would be a strong consideration, especially in recognizing Lodi's need for a certain amount of risk exposure. He shared that Lodi purchases, sells, and burns an enormous amount of wholesale gas, the most of any member of NCPA, and would benefit from participating in a contract with a gas index. This would leave Lodi options toward building generation and moving into it, and in fact Lodi is participating as a member, in NCPA resource planning. While we enjoy the benefits of joint action and partnership with NCPA, it is only to the extent that it is mutually beneficial. Lodi currently has 25 megawatts of a 45 MWh deal through NCPA, but our particular individual needs place us out in front. The City's first duty is to adhere to the schedule to meet the needs and maintain quality service to the customer, and to renegotiate the Calpine agreement toward lowering Lodi's risk position by at least 50%.

At the request of Mayor Pro Tempore Hitchcock, Mr. Vallow shared that during the energy crisis a variety of solutions were implemented, among them buying contracts, relying on cash reserves, or purchasing large amounts of energy from Western. While it now appears that Western was a better buy, currently at $20 MWh, it was the more expensive power when Western proposed building lines for shared power in 1988. He stated that in retrospect the cheapest action would have been to wait out the market for four months, but at that time it appeared Lodi would then be looking at a $220 MWh power market the following year. Lodi looked for stability and the ability to weather out the market based on financing and cash reserves. While we spent an extra $10 million due to rising costs, we did not spend the expected $22 million.

Council Member Nakanishi stated he would be comfortable with 80% generation and 20% market purchase. Mr. Vallow stated that the future may call for municipalities to join an Independent System Operator (ISO), which would call for a new structure, a metered substation to be located just inside the City. He stated that every KWh generated would be exempt from ISO charges, and that while not a moneymaker, this would generate savings to Lodi by cutting and maintaining costs. He shared that the best strategy is to be self-sufficient, and Lodi is moving in that direction while working to lower customer costs through programs such as the Home Comfort Discount.

## D. COMMENTS BY THE PUBLIC ON NON-AGENDA ITEMS

None.

## E. ADJOURNMENT

No action was taken by the City Council. The meeting was adjourned at 8:18 a.m.

ATTEST:

Jacqueline L. Taylor
Deputy City Clerk

# Energy Portfolio Restructure

## Shirtsleeve

## August 20, 2002

# Goals Of Restructuring

- Reduce level of counter party risk
- Shape resource portfolio to more closely follow load profile
- Shape bulk power cost to more closely match load/revenue growth
- Accelerate growth of cash reserves
- Maintain regional advantage in terms of rates

# Financial Comparison
# Bonds Vs. Energy Contracts

**Are they financially the same? Short answer: YES**

**Bonds**: as interest rates vary, underlying value varies
**Energy**: as energy prices vary, underlying contract value varies

**Bonds**: when interest rates drop, refinancing becomes an option
**Energy**: when energy prices drop, energy restructuring becomes an option

**Bonds**: A successful refinancing maximizes present value saving
**Energy**: A successful restructuring maximizes present value savings

# Current Conditions

- We have a 10 year contract with Calpine 25mw – base load @ $65 / MWh

- Contract results in an annual cash flow stream - just like a bond payment stream

- Long term power prices have dropped to historically low levels (just like interest rates)

# Proposal

- Defease ("blowup") existing contract by paying "mark-to-market" difference discounted at Calpine's cost of capital
- Finance present value of "mark-to-market" at our cost of capital
- Replace power contract with contract which is better suited to our resource needs
- Structure repayment stream to smooth out annual bulk power costs

# A Current Conversation

- **What if power prices rise after the restructuring? Shouldn't we wait and see?**

  If power prices rise, it just means others are paying more. It would not mean that we would have been paying less.

  Our objective is to lower our costs, period.

- **We shouldn't have entered into the contract in the first place!**

  I agree. After all, predicting the past is much more accurate then predicting the future. (Care to make a bet on the last NBA playoff series?)

- **When are our rates going to drop?**

  No promises during this fiscal year, but I can predict never if we don't make concerted efforts to lower current costs now.

# Conversation - Continued

- **When do you want to do this restructuring?**
  Last May, but since that is no longer a reasonable option, ASAP (NOW!).

- **I see this as just another debt for the city!**
  Hello! We currently have a long term payment obligation! We are simply advocating making it less risky and cheaper!

- **I still don't think we should have entered into that contract!**
  I'll take the Lakers and give you 7 points. Care to bet?

- **The Lakers won by more than seven points.**
  See how much easier the past is to predict?

## Lodi Power Costs with and without Restructuring